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No. 90-1491

IN THE
Supreme Court of the United States
OCTOBER TERM, 1990

UNION BANK,
Petitioner,
vs.
HERBERT WOLAS, Chapter 7 Trustee
for the Estate of ZZZZ BEST CO., INC.,
Respondent.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF OF CALIFORNIA BANKERS ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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INTERESTS OF *AMICUS CURIAE*

The California Bankers Association ("CBA"), organized as a California nonprofit corporation, is a trade association with over 450 members. CBA's members include virtually every commercial bank in California.

The members of the CBA have a significant stake in the outcome of this case. The Ninth Circuit's elimination of the ordinary course of business exception to preference actions for long-term loans,

and perhaps all bank loans, will adversely affect CBA members. Unless the decision of the Ninth Circuit is reversed, CBA members will not be able to defend against bankruptcy preference actions by proving that they had dealt with their borrowers on ordinary business terms during the borrowers' unfortunately unsuccessful efforts to avoid bankruptcy. Instead, California banks, and other financial institutions in jurisdictions following the Ninth Circuit, will lose a strong incentive to continue to provide credit to borrowers who may have suffered a down-turn, but remain able to service their debts in the ordinary course of business.

SUMMARY OF ARGUMENT

The Ninth Circuit based its holding below on a fundamental misconception about the nature of the ordinary course of business exception. It viewed the exception as being essentially indistinguishable from the "contemporaneous exchange" exception separately provided for in the preference statute. This error formed the basis of the Ninth Circuit's ruling that the ordinary course of business exception is not available for long-term credits.

Ordinary course of business payments have been protected throughout the history of the preference laws of the United States not because of a solcitude for payments made in exchange for recent extensions of credit. Rather, they are protected in order to create incentives which will deter the "race of diligence" and lead to constructive debtor/creditor behavior so that fewer bankruptcies will occur. These goals are at least

as important and realizable in the case of long-term credits as short-term credits. The decision below should be reversed.

ARGUMENT

I
INTRODUCTION.

a. Overview.

Section 547(c)(2) of the Bankruptcy Code, 11 U.S.C. § 547(c)(2) (1979 & Supp. 1991), as first enacted in 1978, provided that the ordinary course of business exception in preference actions was available only to creditors who received the challenged payment within 45 days after creation of the debt on which the payment was made.[1] As originally drafted, the exception therefore could only cover payments made

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[1] Section 547(c)(2), as enacted in 1978, read:

> (c) The trustee may not avoid under this section a transfer—
>
> * * *
>
> (2) to the extent that such transfer was—
>
> (A) in payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee;
>
> (B) made not later than 45 days after such debt was incurred;
>
> (C) made in the ordinary course of business or financial affairs of the debtor and transferee; and
>
> (D) made according to ordinary business terms;

Bankruptcy Reform Act of 1978, Pub. L. 95-598, 92 Stat. 2549 at 2598.

within an ordinary billing cycle typical for short-term credit transactions. *Barash v. Public Finance Corp.*, 658 F.2d 504, 511 (7th Cir. 1981).

The 45-day limitation was deleted in the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 462(c), 98 Stat. 333, 378 (1984).[2] The wholesale elimination of the 45-day limitation was not qualified in any fashion. Thus, under the plain language of the statute, an otherwise preferential payment could be exempted from preference recovery even if the invoice and payment came months, if not years, after credit was first extended, so long as the payment was (1) made on a debt incurred in the ordinary course of business of the debtor and creditor, (2) made in the ordinary course of business of the debtor and creditor, and (3) made according to ordinary business terms. 11 U.S.C. § 547(c)(2)(A)-(C). There is no longer any requirement that the payment be made within 45 days after the debt was incurred.

Since the 1984 Amendments, the Sixth Circuit, relying on the plain language of the statute, held that "[b]y eliminating the 45-day limitation, and neither stating nor implying any other limitation, Congress's language left the field open to long-term consumer debt for exception under § 547(c)(2)." *Gosch v. Burns (In re Finn)*, 909 F.2d 903, 908 (6th Cir. 1990). In

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[2] That section of the Act provided:

"Section 547 of title 11 of the United States Code is amended in subsection (c)(2) thereof by striking out subparagraph (B) of such subsection, and by redesignating subparagraphs (C) and (D) thereof as subparagraphs (B) and (C), respectively." *Id.*

addition, the Tenth Circuit has held that the "broad language of § 547(c)(2) and the intent that this section apply to situations outside of the trade credit arena" makes the exception available, at a minimum, to commercial creditors holding savings certificates with maturities of up to one year (reserving determination as to whether the exception may be employed by creditors under longer term instruments). *Fidelity Sav. & Inv. Co. v. New Hope Baptist*, 880 F.2d 1172, 1176 (10th Cir. 1989). Moreover, the Seventh Circuit based its controversial *Deprizio* decision in part on an assessment that the "ordinary course of business" exception to a preference action is available to long-term commercial lenders. *Levit v. Ingersoll Rand Fin. Corp. (In re Deprizio Constr. Co.)*, 874 F.2d 1186, 1200 (7th Cir. 1989). Only the Ninth Circuit has concluded that the plain meaning of the amended statute should be ignored, issuing two opinions, including the case below, which together exclude virtually all commercial loans from the protection of the "ordinary course of business" exception as a matter of law. *Wolas v. Union Bank (In re ZZZZ Best Co.)*, 921 F.2d 968, 969 (9th Cir. 1990); *CHG Int'l, Inc. v. Barclays Bank (In re CHG Int'l, Inc.)*, 897 F.2d 1479, 1483 (9th Cir. 1990).

b. The Ninth Circuit's Rationale.

The Ninth Circuit's interpretation of the ordinary course of business exception is founded upon a fundamental misconception about the nature of the exception and its relationship to the policies underlying the preference statute. In the *CHG* decision, the progenitor of the case below, the Ninth Circuit wrote that the "rationale for the old 'current expense rule' and for the section 547(c)(2) ordinary course of

business exception is the same." *In re CHG Int'l*, 897 F.2d at 1483. Thus, the Ninth Circuit apparently reasoned that an ordinary course of business payment can only be a payment which "does not diminish the estate, is not for an antecedent debt, and allows the debtor to remain in business." *Id.* On this analysis, the Ninth Circuit has concluded, as a matter of law, that payments on account of long-term debt could not fall within the exception because "nothing is exchanged at the time of the payments with the debtor which helps him to continue in business. There is merely an outflow of money from the estate." *Id.* at 1485.

The now extinct 45-day rule was seen by the Ninth Circuit as furthering the purposes of the exception because "'payments made within the 45-day credit cycle were so close to "contemporaneous" that they were not to be treated as payments on "antecedent" debts.'" *Id.* at 1483 (citation omitted). The deletion of the 45-day requirement was seen by the Ninth Circuit as nothing more than the elimination of a bright line test for such virtually "contemporaneous" transactions. The Ninth Circuit thereby justified its apparent conclusion that courts applying the exception must determine whether the challenged payment was so close in time to the incurring of the debt that the payment "[did] not diminish the estate, [was] not for an antecedent debt, and allow[ed] the debtor to remain in business."[3]

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[3] The Seventh Circuit adopted a similar analysis of the ordinary course of business exception when the statute included the 45-day limitation. *Barash v. Public Fin.*, 658 F.2d at 504. After the 1984 amendments, however, the Seventh Circuit concluded that the ordinary course of business exception is available for payments on

II
THE ORDINARY COURSE OF BUSINESS EXCEPTION WAS DESIGNED TO DISCOURAGE UNUSUAL ACTION BY THE DEBTOR AND ITS CREDITORS, NOT TO PROTECT PAYMENTS IN EXCHANGE FOR RECENT EXTENSIONS OF CREDIT.

a. Ordinary Course Payments Are Protected *Not* Because They Often Do Not Diminish The Estate, But Because The Exception Helps Avoid Bankruptcy In the First Instance.

The Ninth Circuit simply is incorrect in its assumption that "the rationale for the old 'current expense rule' and for the section 547(c)(2) ordinary course of business exception is the same." While the ordinary course of business exception may indeed "complement" the contemporaneous exchange exception, *In re CHG Int'l*, 897 F.2d at 1483, *nothing* in the legislative history or in decades of pre-Code law even suggests that the purpose of the ordinary course of business exception is to protect only those payments which do not diminish the estate. No doubt, many payments made in the ordinary course of business—including, significantly, interest payments made to maintain credit availability under long-term revolving lines of credit—have the additional salutary effect of keeping a debtor supplied with the capital, goods and services needed to avoid bankruptcy.[4] However, the legislative history of the 1978 Code and a long history of cases under the former Bankruptcy

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account of long-term debt. *See In re Deprizio*, 874 F.2d at 1200.

[4] *See* discussion *infra* at pp. 12-13.

Act show that the corollary purposes of the exception are to prevent creditors from engaging in the so-called "race of diligence" and to give creditors an incentive to work with debtors on ordinary business terms so that bankruptcy might be avoided.

In this sense, the ordinary course exception "complements" the contemporaneous exchange exception, because a debtor is unlikely to have the funds to pay for its current expenses if it is being dismembered by assaults from its long-term creditors. Moreover, certain ordinary course payments on account of long-term revolving lines of credit can advance the policies behind both exceptions: the bank's continued willingness to maintain an ordinary credit relationship will give the borrower access to the capital it needs to fund its ongoing operations and to remain profitable and solvent. The important point, however, is that the ordinary course of business exception is fundamentally grounded on a different rationale than the other exceptions set forth in section 547(c).

The ordinary course of business exception was enacted to create an incentive structure that would help "leave undisturbed normal financial relations, because [the exception] does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy." House Comm. on the Judiciary, Bankruptcy Reform Act of 1978, H.R. Rep. No. 595, 95th Cong., 1st Sess. 373, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 6329 (hereinafter House Report). *See Coral Petroleum Inc. v. Banque Paribas-London*, 797 F.2d 1351, 1355 (5th Cir. 1986), *reh. denied*, 801 F.2d 398 (5th Cir. 1986); 4 Collier on Bankruptcy ¶ 547.01 at

547-11 (15th ed. 1991). By penalizing aggressive creditor action and rewarding cooperative behavior, the exception helps reduce the number of bankruptcies because borrowers are granted access to the capital, goods and services needed to earn their way out of financial difficulty. House Report 177-78 ("The protection thus afforded the debtor [by the preference section] often enables him to work his way out of a difficult financial situation through cooperation with all his creditors."). *See also Coral Petroleum*, 797 F.2d at 1355 (quoting House Report); 4 Collier on Bankruptcy ¶ 547.01 at 547-11 (15th ed. 1991).

b. The Focus Of The Exception Is On The Objective Conduct Of The Creditor And Debtor, In The Context Of Industry Standards.

The three-part test of section 547(c)(2)—ordinary debt, ordinary payment, according to ordinary business terms—has neither an express nor implied requirement of balance sheet neutrality. Nothing in the statute requires proof that the challenged payment did not diminish the assets of the debtor. The ordinary course of business exception examines in the first instance the *conduct* of the creditor and debtor, and *refuses to protect payments which are the result of unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy.* Payments which would otherwise constitute avoidable preferences are, however, protected if the objective facts surrounding the transactions and the observable history of the parties' dealings indicate that the creditor and debtor conducted themselves in a constructive, fair manner during the preference period.

This focus on *conduct* has been the hallmark of the analysis of the avoidability of ordinary course of business payments throughout the history of the bankruptcy laws of the United States. As set forth more fully below, the earliest preference statutes permitted the recovery of preferences only if the trustee could prove that the creditor had reasonable cause to believe that he was receiving a preference (under the 1898 Act[5]) or reasonable cause to believe that the debtor was insolvent at the time of payment (under the 1938 Chandler Amendments to the former Bankruptcy Act). *See* 3, pt. 2 Collier on Bankruptcy ¶ 60.06 at 779 n. 13 (14th ed. 1977) (detailing changes in preference statute effected by 1938 amendments).[6] Although there was no *express* exception for ordinary course payments, the issue arose under these versions of the preference statute because the receipt of such payments was consistent with the behavior of a creditor who had no reason to believe that the debtor was favoring him or that the debtor was insolvent. Similarly, payments not in the ordinary course of business were evidence of improper intent.

Today, under the Bankruptcy Code, a trustee no longer must prove that the creditor knew or should have known that his debtor was favoring him or was

[5] Bankruptcy Act of 1898, 30 Stat. 544 (as amended) (repealed), *reprinted in* 10 Collier on Bankruptcy 1783 (14th ed. 1977).

[6] The focus on the creditor's reasonable state of mind predated even the 1898 Bankruptcy Act. The Bankruptcy Act of 1867 required the trustee to prove that the creditor "had reasonable cause to believe that (1) such person was insolvent and that (2) such transfer was in fraud of the act." 3, pt. 2 Collier on Bankruptcy ¶ 60.05 at 770-71 (14th ed. 1977).

insolvent. As one of the leading bankruptcy treatises explains:

> *intent* or *motive* is not a material factor in the consideration of an alleged preference under § 547. Generally speaking, it is the *effect* of a transaction, rather than the debtor's or creditor's intent, that is controlling.

4 Collier on Bankruptcy ¶ 547.01 at 547.12 (15th ed. 1991). The preference statute is, thus, a strict liability statute which focuses on the *effect* of the pre-petition payments rather than on the *intentions* of the debtor and creditor.

The ordinary course of business exception, however, provides an important counterbalance to this strict liability, effect-oriented scheme by permitting a creditor to defend against a preference action by showing that, by virtue of the objective "ordinariness" of the transactions and payments, the creditor did not engage in a race of diligence and the debtor did not attempt to prefer him over other creditors. Thus, while intent is no longer relevant, the deterrence policy of the preference statute is advanced. The creditor is permitted to show that the objective, observable *conduct* of the parties comported with the constructive, fair behavior the preference statute is designed to induce.

No doubt, the burden of proof has shifted from the trustee to the creditor, 11 U.S.C. § 547(g) (1979 & Supp. 1991), but the issue of the conduct of the parties remains relevant to the determination of whether a pre-petition payment is an avoidable preference. The exception is a limited trade-off of the trustee's power to recover otherwise preferential payments in the hope

that, as a result of the exception, creditors and debtors will conduct themselves in a fair and constructive manner so that fewer bankruptcies will occur.

c. The Policy Of The Ordinary Course Of Business Exception Is Supported By Extending It To Long-Term Debt.

Viewed in this context, the question whether the ordinary course of business exception is available to creditors who received payments on account of long-term debt leads to an entirely different answer from that given by the Ninth Circuit. Aggressive creditor action is *at least* as deleterious to a troubled company when the creditor is the holder of a long-term debt instrument as when the creditor is a short-term trade supplier. A debtor's long-term loans are often the largest debts it owes and these loans often constitute or are tied to revolving or operating lines of credit needed by the borrower to remain in business.

Indeed, in modern commercial finance, the debtor's long-term lender is often the debtor's single most important "supplier." Many long-term loans are revolving lines of credit in which the debtor receives new funds, at its discretion, in exchange for continued timely interest payments to the lender. That is to say, the debtor's regular timely payments of interest are the condition precedent to the continued availability of credit under the line. Because such payments are made to the bank, the debtor has the ability to make new draws on the line—draws which can well exceed the amount of the regular timely payments of interest made by the debtor during the same time period.

Such payments do not diminish the estate. Rather, they enhance the working capital of the debtor

and can be the lifeblood of the debtor's efforts to remain in business. Nonetheless, the Ninth Circuit in the case below "fail[ed] to see any significant difference between a revolving line of credit and an ordinary loan for purposes of § 547(c)(2)." *In re ZZZZ Best Co.*, 921 F.2d at 969. In this regard, the Ninth Circuit misapplied even on its own incorrect analysis by failing to see that a long-term commercial lender on a revolving line of credit can be an important "supplier" of the very capital a debtor needs to buy goods and services and remain a viable member of a productive economy.

It is unclear why Congress initially imposed the 45-day limitation in the 1978 codification of the ordinary course of business exception. No legislative history addresses this feature of the legislation. The 45-day limitation had no antecedent in either the case law construing or the language of the former Bankruptcy Act. The limitation was deleted in 1984, again with sparse legislative history to explain the purpose of the deletion.

Whatever the reasons, the policies expressed by the ordinary course of business exception can be applied to long-term credits, as well as short-term credits. There is no ambiguity in the language of the exception, the policy supporting the exception applies with at least equal force to both types of credits, and enforcing the statute as written is entirely consistent with the overall purposes of the preference statute.

III
THE ORDINARY COURSE OF BUSINESS ISSUE HISTORICALLY HAS RELATED TO THE DETERRENCE POLICY OF THE PREFERENCE STATUTE.

a. Cases In General.

The history of the preference statute since the 19th century has been one of the balancing and refinement of rules to further two complementary policies: preventing the "race of diligence" and maximizing equality of distribution. House Report 178. The ordinary course of business issue has been an express part of this policy since at least the Bankruptcy Act of 1867, 14 Stat. 517, as amended, (repealed by Act of June 7, 1878, 20 Stat. 99), *reprinted in* 10 Collier on Bankruptcy 1747 (14th ed. 1977). Section 35 of that act provided that a transfer during the four months prior to bankruptcy could be avoided by the trustee upon proof of the transferor's fraudulent intent and that "if such . . . transfer . . . is not made in the usual and ordinary course of business of the debtor, the fact shall be prima facie evidence of fraud." *Id.* at 1768-69.

Initially, the deterrence policy had a predominant effect on the outcome of preference actions, because the trustee was required to prove as part of his *prima facie* case that the creditor knew or should have known that it was (under the 1898 Act) receiving a preference[7] or (under the 1938 Chandler Amendments to the former Bankruptcy Act) taking a payment from an insolvent. Thus, section 60b of the former Bankruptcy Act, 11 U.S.C. § 60b (1970), provided that a preference "may be avoided by the trustee if the creditor receiving it or to be benefitted thereby or his agent acting with reference thereto has, at the time when the transfer is made, *reasonable cause to believe that the debtor is insolvent.*" (emphasis added). *See* 3, pt. 2 Collier on Bankruptcy ¶ 60.52[1] 1051 (14th ed. 1977). The trustee had the burden of proof on this issue. *Vance v. Dugan,* 187 F.2d 605 (10th Cir. 1951), 3, pt. 2 Collier on Bankruptcy ¶ 60.54[1], at 1075 (14th ed. 1977).

This element of the *prima facie* case was troubling to the drafters of the 1978 Bankruptcy Code because proof of the element was difficult, even though the test was expressed in terms of the creditor's "reasonable cause to believe," rather than actual state of mind. House Report 178. Moreover, the House Report explained that the focus on the debtor's reasonable state of mind furthered only the deterrence policy, not the equality of distribution policy of the preference statute. *Id.* Accordingly, the preference section of the former Bankruptcy Act was replaced in the Code with a provision that eliminated the reasonable cause to believe element from the trustee's case in chief.[8]

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[7] Section 60b of The Bankruptcy Act of 1898 required proof by the trustee that "the person receiving [a challenged transfer] . . . shall then have such reasonable cause to believe that the [receipt of such transfer] would effect a preference." 10 Collier on Bankruptcy 1783, 1816 (14th ed. 1977).

[8] The requirement was deleted in two phases. Initially, such proof was required only for preference actions against an insider during the period between 90 days and one-year preceding the filing of the bankruptcy petition. Bankruptcy Reform Act of 1978, Pub.L. 95-598, 92 Stat. 2549 at 2598 (enacting and codifying 11 U.S.C. §

It is important to recognize, however, that the new formulation of the preference statute did not abandon all inquiries into the conduct of the debtor and its creditors. That is to say, the new formulation did not abandon the policy of deterring the race of diligence. On the contrary, the question of the parties' conduct was removed from the case in chief and made part of the affirmative defenses, or exceptions, to the preference claim.

This is perhaps best demonstrated by an examination of how courts employed the concept in preference actions under the former Bankruptcy Act, before the concept was codified as a preference exception in the 1978 Code. *See Midlantic Nat. Bank v. New JerseyDep't of Env. Protection,* 474 U.S. 494, 501 (1986) ("The normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific."). Under the former Bankruptcy Act, a creditor could defend against any showing by the trustee that a creditor had reasonable cause to believe that the debtor was insolvent by submitting evidence that the payment was received in the ordinary course of business:

> Payments received by a creditor in the ordinary course of business with an insolvent debtor are not necessarily

547(b)(4)(B)(ii) (prior to 1984 amendment). No such proof was required during the 90-day preference period applicable to all creditors. *Id.* Later, the "reasonable cause" element was entirely deleted. Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. 98-353 § 462(b), 98 Stat. 333, 378 (amending 11 U.S.C. § 547(b)(4)(B)).

> voidable. The acceptance of payments with no special purpose of obtaining advantage over other creditors but in accordance with the creditor's general method of collecting outstanding accounts will not give rise to reasonable cause to believe that the debtor is insolvent.

3, pt. 2 Collier on Bankruptcy ¶ 60.54[4], 1082.1. (14th ed.). Indeed, this Court has long recognized that the reasonable cause to believe element of the old preference action could be established by the mere proof that a transfer was not made in the ordinary course of business. *Wager v. Hall,* 83 U.S. (16 Wall.) 584, 600 (1873) ("It is prima facie evidence of [transferee's reasonable cause to believe transferor was insolvent at time of transfer] if the conveyance is not made in the usual and ordinary course of business of the debtor.")

Thus, in the case of *In re First National Bank of Louisville,* 155 F. 100, 104 (6th Cir. 1907), a case under the 1898 Act, the court held that the trustee had failed to prove the creditor had reasonable cause to believe that the debtor intended a preference because a creditor "may well suppose that the debtor while paying him his debt in the common course of business is acting without any purpose of giving special favor." Similarly, in *Grandison v. Robertson,* the court reasoned:

> The Bankruptcy Act does not take away from a banker the right to transact business with his customer in the ordinary way. He may take renewal notes in extension of credit and receive

> partial payment of his debt, and has the right during the continuance of their relations to presume that his debtor is solvent and carrying on business in the usual way; and if it turns out that the debtor was insolvent the creditor may receive payment without incurring the liability of having to restore such payment when bankruptcy intervenes.

220 F. 985, 987 (W.D.N.Y. 1915), *modified on other grounds*, 231 F. 785 (1916). And in *Miceli v. Morgano*, 36 F.2d 507 (W.D.N.Y 1929) the court wrote that it "has frequently been decided that mere suspicion is not enough to put a creditor on inquiry as to the financial condition of this debtor, and charge him, upon the payment of his account in the ordinary course of business, with reasonable cause to believe that a preference over other creditors was given to him." *Id.* at 509. The case of *In re Singer & Sirotta, Inc.*, 27 F. Supp. 276 (S.D.N.Y.1939), is to like effect. There, the district court reversed a bankruptcy referee's finding that no preference had been paid where, *inter alia*, the "payments were not in the ordinary course of business." *See also Burk v. Musk*, 51 F.2d 581 (E.D. Ill. 1931) ("The unusual nature of the transaction, in connection with all the circumstances, raises such a presumption that it can only be overcome by proof on the part of the preferred creditor that he took the proper steps to find out the pecuniary conditions of the debtor."), *aff'd* 58 F.2d 77 (7th Cir. 1932).

More recently, in the case of *Holahan v. Gore*, 278 F. Supp. 899, 902-03 (E.D. La. 1968), the court wrote that the "usual or unusual nature of the transfer" is one of the factors to be considered in determining

whether the creditor had reasonable cause to believe the debtor was insolvent. And in *Katz v. First Nat'l Bank of Glen Head*, 568 F.2d 964 (2d. Cir. 1976), *cert. denied*, 434 U.S. 1069 (1978), the Court reversed and remanded for trial the question whether a build-up of deposits by a debtor in a bank account with his creditor bank was made in the ordinary course of business (and therefore not a transfer) or with the intention of making the deposits available for set-off by the bank. *Id.*, at 971 ("Here the trustee alleged facts from which it couild be inferred that the bankrupt did not make the deposits in its Glen Head account in good faith; that the deposits were not made in the regular course of its business . . .").

Thus, contrary to the Ninth Circuit's analysis, the ordinary course of business test was not created out of whole cloth by the 1978 Bankruptcy Code. It has been part of the fabric of the preference statute since at least the 1860's. Originally, it was raised in connection with the trustee's attempt to meet his burden of proof that the creditor knew or should have known that it was receiving a preference. The change effected by the Bankruptcy Code was simply to remove it from the case in chief and put it into the creditor's affirmative defenses. *See* 11 U.S.C. § 547(g) ("The creditor or party in interest against whom recovery or avoidance is sought has the burden of proving the nonavoidability of a transfer under subsection (c) of this section.").

This shifting of the burden of proof, however, did not change the essential purpose of the exception. The ordinary course of business exception focuses on the objective *conduct* and prior course of dealings of the parties for the same reason that the "reasonable

cause to believe" element focused on the state of mind of the creditor: to prevent the race of diligence. Of course, preventing the race of diligence has significant positive consequence for the viability of the debtor generally. Even if the debtor is unable to avoid bankruptcy, the measured conduct of its creditors before bankruptcy could well leave the estate in a better position to distribute more assets to its creditors in an equitable fashion. Thus, the ordinary course of business defense is consistent with the equality of distribution goals of the preference statute. Fundamentally, however, examining whether a payment is made on account of an ordinary debt, in the ordinary course of business of the debtor and creditor and according to ordinary business terms goes to the issue of preventing the race of diligence.

b. Under Former Bankruptcy Act, The Ordinary Course Of Business Issue Arose In Cases Involving Credits Of Every Nature. The Issue Was Not Limited to Trade Or Other Short-Term Creditor Cases.

There appears to be no decisional or statutory authority under the former Bankruptcy Act which even suggests that the ordinary course of business issue was relevant only in short-term or trade credit situations. Rather, the cases span a multitude of fact patterns, including short and long-term debt, in a range of commercial contexts. For example, in *In re First National Bank of Louisville*, 155 F. 100, the challenged payments were made to a bank on a series of loans

secured by accounts receivable.[9] *Grandison v. Robertson*, 220 F. 985, involved commercial loans by private bankers secured by accounts receivable and initially made over one year before the debtor became insolvent.[10] In *Katz v. First Nat'l Bank of Glen Head*, 568 F.2d 964, the recipient was a bank which had made a solitary advance over two and one half years before the debtor filed bankruptcy! In each case the courts' preference analysis looked to whether the challenged payments were made in the ordinary course of business. No question was even raised whether it was appropriate to do so for payments on account of such apparently long-term credits.

CONCLUSION

There is simply no support for the Ninth Circuit's ruling that the ordinary course of business exception applies only to short-term credit transactions. The legislative history does not support the ruling and the pre-Code case law and bankruptcy statutes argue

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[9] Although the loans in the *First National Bank* case were executed in a series of transactions, the substance of the loans appears to have been virtually identical to a revolving line of credit, a credit which the Ninth Circuit has concluded is not within the ambit of the ordinary course of business exception.

[10] In *Grandison* the court found that the bankruptcy preference statute had not been violated because the private bankers had no reasonable cause to believe that the debtor was insolvent. The payments were nonetheless recovered by the trustee under a state law preference statute which expressly focused only on the intention of the debtor, not the transferee. *Grandison v. Robertson*, 220 F. at 988-99.

strongly for the contrary position. The ordinary course of business issue has long been part of the preference law of the United States and it has been consistently invoked to create incentives against the race of diligence. The Ninth Circuit's rule would eliminate an important incentive for banks and other commercial lenders to maintain credit availability for and work with borrowers who, though weakened, are able to continue to make ordinary course payments. This incentive is important both to banks and to debtors, especially those who are party to revolving line of credit agreements.

The decision below should be reversed.

Dated: July 8, 1991

Respectfully submitted,

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